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**The Property Tax: Its Role and Significance in Funding State  
and Local Government Services**

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*Prepared for*

**The National Association of Realtors  
National Center for Real Estate Research**

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## **EXECUTIVE SUMMARY**

This report, produced by the George Washington Institute of Public Policy, focuses on the incidence of the property tax and its significance in funding state and local government services. The purpose of the study is to help policy makers, researchers, and others interested in local government finance to better understanding the role of the property tax.

An overview of the historical and current role of the property tax as an important source of revenue, including a discussion of trends, demonstrates how entrenched the property tax is, and explains the circumstances and conditions that contribute to the current property tax environment. The second section of the report outlines the strengths and weaknesses of the property tax today, while the subsequent section addresses the prevailing views and current debates among public finance analysts. The final section describes the variation in use of the property tax, and how the political process gave rise to much of that variation.

### **History and Trends**

The property tax has a long tradition in the U.S., dating back to the colonial period. The activities of the colonial government, mainly limited to defense and justice, were finance by contributions of landowners in proportion to the value of their properties. The extent and nature of the property tax has varied throughout our national history, becoming at times a revenue mechanism of the states, federal government, and local government. Federal government use of the property tax was generally associated with national military events. States used the property tax early in the history of the U.S., primarily to recover financially from the War of Independence. Since World War II, the property tax has primary been the province of local government.

A key development in the history of the property tax that shapes the tax environment today is the “taxpayers’ revolution,” begun in the 1970s. California’s Proposition 13 was the first of several voter-approved, state-level caps on the ability of local government to raise revenue through the property tax. Similar initiatives followed in Idaho and Massachusetts.

Despite these limitations, sharp increases in property values fueled rapid growth in property tax revenues at all levels of government that assess property taxes, rapid growth in the dollar value of state and local property tax receipts, and per capita collections. Introduction of other types of taxes, mainly the sales and income taxes, have diminished the share of property tax as part of all state and local revenue.

### **Policy Issues**

The property tax has a number of strengths. Because it has been in place since the earliest days of settlement, it is well accepted. Generally, it is a reliable and stable source of revenue for local governments, relying on commodities (land and buildings) that are geographically fixed within jurisdictional boundaries. Growth in property values has boosted property tax revenues, and this helps local governments finance growing costs. Longstanding land record systems facilitate collection and compliance with the property tax, although exemptions, credits, and the proliferation of nonstandard commercial development can complicate administration of the tax. Another advantage of the property tax is that there is a rational nexus between the taxes and the benefits; local revenues are used to fund services and facilities for local residents. The use of local property tax revenue for local spending also allows the taxpayer to participate in the decision how to spend tax money.

On the other hand, the property tax also has some drawbacks. It is unpopular, in part because it is highly visible. Assessments are supposed to be based on fair market value, but in a

rapidly changing real estate market, that value can be difficult to determine, and hence is considered by some to be unfair. Tax incentives and reductions associated with economic development have contributed to an increasing share of property tax on residential property.

The structure of the property tax has been shaped and constrained through the political process as taxpayers register their unhappiness with elected officials and through referenda. The school finance crisis has put additional pressure on the property tax. Revenue caps are in place in many states, as are a number of targeted tax relief provisions. Taxpayer unhappiness with the property tax has motivated constitutional and statutory limitations on the tax, as well as the proliferation of exemptions and other forms of relief. Government property and property owned by charities are not subject to the property tax, so the presence of either of these uses in a jurisdiction limit revenues.

### **Incidence**

“Incidence” explores the impact of a tax and how the impact of a tax is distributed across taxpayers. This analysis goes beyond simply tallying the tax bills by group to acknowledge that tax shapes behavior. A tax is an added cost of engaging in an activity, such as owning property. As an added cost, it prices some participants out of that market, either because they no longer have the means to engage in that activity or because some other activity looks more worthwhile for the cost.

Some have argued that the property tax is not a tax in this sense, but rather a mechanism for landowners and renters to pay for services provided by the community. An alternative to this “benefits view” is the “new view” that argues that taxing property erodes its value.

Other tax economists advocate higher taxes on land than on improvements. Because land is immobile, the tax does not change behavior, making this tax more efficient. However, land

may only be immobile in the short run, as property owners and potential property owners shift to other jurisdictions with more favorable tax environments.

The tax environment in a jurisdiction and the associated mix of goods and services is one basis on which people sort themselves across jurisdictions. This kind of differentiation allows market participants to match their preferences for locally-provided goods and services, given their willingness and ability to pay for those goods and services. While this is an efficient arrangement, it may not be sufficiently equitable. Whether the tax is progressive in nature or regressive in nature is a matter of debate. Variations in rate structures and targeted relief provisions further complicate the issue.

### **Variations in Use of the Property Tax**

Local governments in the Northeast and Midwest rely more on property taxes than do local governments in the South or West, and within regions, practices within individual states vary greatly. The property tax environment can be a factor in competition for economic development prospects. Greater local government reliance on the property tax is associated with a greater degree of local autonomy vis-à-vis the state.

Today, school districts are the most heavily dependent on the property tax, and the largest share of all property tax revenues goes to school districts. Townships are also highly dependent on the property tax, typically not receiving aid or other kinds of revenue from the state.

## **A. INTRODUCTION TO THE PROPERTY TAX**

### **1. Historical Perspective**

There is an old shibboleth that an old tax is a good tax. If true, then the property tax must be considered one of the best. The first recorded instance of property taxation was the Athenian direct tax levied at the time of Solon in 596 B.C. Society has been taxing property in one form or another ever since. The property tax has been levied in North America since the early 17<sup>th</sup> Century. The section provides a brief history of the property tax in the United States.

#### ***a. Colonial Times***

The early American colonies taxed property to support what would be considered minimalist government by today's standards. Colonial governments provided few services apart from modest defense and courts. The colonies' sparse populations negated the need for more extensive government services. As Rabushka (2002) noted, it took from 1607 to 1630 to reach a combined population of 4,646 in six colonies: Maine, New Hampshire, Plymouth, Massachusetts, New York, and Virginia. Even by 1640, after the establishment of new settlements in Rhode Island, Connecticut, and Maryland, the total population of the colonies was only 26,634. The population of the colonies would not reach 50,000 until mid-century (Rabushka 2002).

The American experience with the property tax can be traced to the Massachusetts Bay Colony, which in 1638 passed the first revenue laws<sup>1</sup>. The first tax law of the General Court, as the colonial legislature was then known, ordered that "in all rates and publique charges, the

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<sup>1</sup> The first tax in colonial America was not on property. In 1619, Virginia levied a poll tax on its citizens.

towns shall have respect to levy every man according to his estate, & with consideration of all of his other abilities, whatsoever.” What this means in modern English is that the colonial local governments could tax property. But the General Court went further by mandating “one general rule & way of rating throughout ye country.” This last provision has been interpreted as the origin of the general property tax law. Each settler in the colony was required to pay a tax in proportion to the total market value of all of his property (Adams 1984, 48).<sup>2</sup>

The property tax imposed by the Massachusetts Bay Colony was based on what was known as the country “rate,” which was intended to be a tax on wealth. The budget process that guided the property tax in 1638 was strikingly similar to that still in place in many parts of America today. The government assessed the value of all taxable property (which included virtually all property). Taxable property in the Massachusetts Bay Colony included land, buildings and improvements, machines, household goods, stock in trade, boats and other vessels, carriages, livestock, mills, and most visible tangible property. The colonial governments (the colony, the provinces, and the towns) determined their spending needs and a rate of tax was applied to the assessed property to generate the necessary revenue. Each level of Massachusetts government applied its own rate to the assessed property.

The colonial period gave rise to the first problems with inadequate assessment -- a problem that has plagued the tax until the present day. Government officials were unwilling or unable to regularly assess property owned in their jurisdictions. By the late 17th Century only two colonies were reassessing property on an annual basis, and most governments did not bother to reassess at all (Fisher 1996).

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<sup>2</sup> This first revenue law differed from that used in England at the time. The English tax was determined by the estimated annual rental income that could be earned from the property and not its fair market value.

The colonial property tax system also gave rise to the first widespread tax evasion and avoidance in America. Not satisfied with relatively low rates, some colonists began concealing otherwise taxable assets. The Massachusetts Bay Colony general property tax suffered from the same administrative problems that future American state and local governments would face when taxing personal property. While the colony could easily assess land, buildings, and large animals, it could not easily find other forms of property. In 1851, the General Court noted that settlers hid property to avoid taxation (Adams 1984, 49). It was during this period that property owners also began to lobby assessors for lower valuations.

The level of taxation was modest in the early colonies. The effective tax rates on land and other real property assets (i.e., improvements) were generally below one percent. The relatively low rates were consistent with the relatively low levels of government expenditures.

### ***b. Federal Property Taxation***

While the property tax has dominated state (during the 19th Century) and local (during the 20th Century) finance, few people realize that the federal government once imposed property taxes. In 1798, the United States was gearing up for a potential war with France. To raise revenue for a larger navy, the Federalist Congress approved a direct tax on land, slaves, and houses. This would be the national government's first of three forays into property taxation. Congress charged Federal officials with assessing property and collecting the tax, but a local board of commissioners was convened in each state to promulgate assessment regulations that would reflect local needs and custom.

The only serious public displeasure with the tax occurred in Pennsylvania where a group of assessors was detained by local militia in what became known as Fries Rebellion. The uprising did not last as Federal troops quickly put down the uprising.

Under the federal property tax, each slave was taxed at 50 cents; houses were taxed at a progressive rate from 2 to 10 mills of value, while the remaining tax to be paid in each state was imposed on land and adjusted to fit the apportionment formula. The 1798 property tax raised approximately \$2 million over the next three years. The federal land tax continued to be collected until 1802, when the Republicans took control of the executive and legislative branches. Newly elected Republican President Thomas Jefferson abolished all internal taxes, including the still controversial whiskey excise tax and the land tax.

The Federal government would once again venture into property taxation to finance the War of 1812. The war had a disruptive effect on trade, which greatly reduced customs revenue. In 1813, Congress again approved a direct tax on property which was assessed and collected by the states. The states were granted a 15 percent tax discount from the anticipated sum apportioned to their citizens if state governments collected the taxes themselves and paid the federal government directly. A majority of states took advantage of this arrangement, which spared the Madison administration the trouble of establishing an extensive bureaucratic infrastructure. The direct property tax was deemed a war time tax and was automatically repealed when hostilities with Britain ended.

The final federal attempt to tax property occurred during the Civil War. The mounting deficit in 1861 prompted Secretary of Treasury Salmon Chase to call for a direct land tax to be collected by each state in proportion to its population. Members of Congress in southern and western states (where the land tax would be particularly burdensome) opposed the plan. Later in 1861, Congress passed a new revenue law that included a national income tax and a land tax. The law was apportioned to the states by population and was to be collected by the state revenue

departments. The Civil War land tax raised nearly \$20 million over the course of the war (Wallis 2000). Congress allowed the tax to expire when the war ended.

***c. Early State Property Taxation***

After financing the War of Independence, the states were saddled with large amounts of debt. This led every state to adopt some form of property tax in the early 1790s. Not all states wanted to tax property. Vermont resisted the tax, preferring to raise revenue by confiscating Tory property. But even Vermont succumbed to its heavy debt and imposed a statewide tax. Most states chose to levy a property tax on all real and some tangible property such as cattle (Wallis 2000). Only four states (Rhode Island, Delaware, Maryland, and New York) attempted to tax all property (Fisher 1996).

Eventually, the federal government assumed most of the states' war time debts and the states found themselves in very good fiscal condition by 1800. Indeed, many states began repealing their property tax systems as their need for revenue decreased. While state property tax revenue spiked during the War of 1812, the decline in property tax revenue continued through the late 1820s.

By 1830, New York, Massachusetts, Pennsylvania, Maryland, Rhode Island, South Carolina, Alabama, Georgia, and North Carolina had abolished their state level property tax levies. In contrast to these eastern states, states on the frontier, in both the North and the South, had few commercial enterprises and banks to tax. Frontier states were heavily dependent on the property tax.

Until the late 1830s only the states west of the Appalachians raised significant revenue from property taxes. In 1835, for example, eastern states raised only two percent of their revenue from property taxes, while western states were raising 34 percent of their total revenue (Wallis

2000). By the end of the 1840s, however, every state had returned to taxing property. In 1848, eastern states were raising 17 percent of their revenue from property taxes, while western states had increased their share to 45 percent (Wallis 2000). The return to state property taxation was prompted by the fiscal crisis brought upon by massive state investment in canals.

Following the success of New York's Erie Canal, many states, particularly those in the west, began building canal systems and investing in other transportation projects. In the 1820s, Ohio began planning a canal that would link up with the Erie. Promoters of the Ohio canals proposed a shift from flat per acre taxation to an ad valorem tax. "Ad valorem taxation not only would increase state revenues, but would also place a larger (and fairer) share of the tax burden on localities where land values rose quickly because of the canals" (Wallis 2000).

Both Indiana and Illinois switched from flat per-acre property taxes to ad valorem taxes when they began their canal projects in the mid-1830s. As in New York and Ohio, the shift to ad valorem taxation was a mechanism used by canal promoters to align the costs and benefits of government investment. Louisiana, Florida, Mississippi, and Arkansas all expanded their investments in banks that would finance state transportation systems with state property taxes. By the mid-1800s, every state was once again taxing property. Unlike the early part of the century, the states would take a much more expansive view of property subject to taxation.

#### ***d. Uniformity***

The fiscal crisis of the 19th Century was a prelude to one of the most significant developments in the history of American property taxation -- the adoption of uniformity provisions. The early state and local system of property taxation, an outgrowth of the general property taxation during the colonial period, was focused on maximizing revenue. That system was not based on identifiable principles. Over time, special interests convinced state and local

governments to tax some forms of property at greater rates than other forms of property. Those with access to political leaders were able to secure exemptions and significant reductions in tax liabilities. Those without such access were subject to higher burdens.

The perceived unfairness of the system and the revenue losses from mounting exemptions caused most states to adopt what are commonly known as uniformity provisions. Uniformity provisions generally provided that all property (real, tangible, and intangible) should be taxed at the same rate.

The general property tax applied to all wealth -- real and personal, tangible and intangible. It was administrated by elected local officials who were to determine the market value of the property, compute the tax rates necessary to raise the amount levied, compute taxes on each property, collect the tax, and remit the proceeds to the proper government. Because the tax was uniform and levied on all wealth, each taxpayer would pay for the government services in exact proportion to his or her wealth.

The uniformity reforms began with news states being formed in the west. These states took the opportunity to incorporate uniformity provisions into their constitutions at the time they were written. In 1796 seven of the fifteen states levied uniform taxes. Twelve taxed some or all livestock. Land was taxed in a variety of ways, but only four states taxed the mass of property by valuation. No state constitution required that taxation be by value or required that rates on all kinds of property be uniform. By the end of the century thirty-three states had included uniformity clauses in new constitutions or had amended old ones to include the requirement that all property be taxed equally by value. A number of other states enacted uniformity statutes requiring that all property be taxed. By the end of the century, virtually every state had adopted some form of uniformity requirement for the taxation of property (see Table 1).

**Table 1. Nineteenth-Century Uniformity Provisions (first appearance in state constitutions)**

<i>State</i>	<i>Year</i>
Illinois	1818
Missouri	1820
Tennessee	1834
Arkansas	1836
Florida	1838
Louisiana	1845
Texas	1845
Wisconsin	1848
California	1849
Michigan	1850
Virginia	1850
Indiana	1851
Ohio	1851
Minnesota	1857
Kansas	1859
Oregon	1859
West Virginia	1863
Nevada	1864
South Carolina	1865
Georgia	1868
North Carolina	1868
Mississippi	1869
Maine	1875
Nebraska	1875
New Jersey	1875
Montana	1889
North Dakota	1889
South Dakota	1889
Washington	1889
Idaho	1890
Wyoming	1890
Kentucky	1891
Utah	1896

Source: Fisher (1996)

The uniformity provisions were designed to end all exemptions, a goal that was never achieved. No state taxed all tangible and real property, even though many constitutions required just that. As the 19th Century progressed, most states amended their constitutions to allow exemptions for property owned by religious organizations and other nonprofits.

***e. The Demise of the General Property Tax***

By the late 19th Century, every state was levying a general property tax. The uniformity provisions adopted during the preceding decades mandated, with few exceptions, that virtually all property were subject to tax. The general property tax dominated state public finance during this period. In 1902, states raised on average 45 percent of their total revenue from the general property tax, far more than any other single source of revenue. But some states, particularly those in the Midwest and west raised a far higher percentage. Illinois, for example, raised 70 percent of its total tax revenue from the general property tax in 1917.

Despite its dominance at the state level, the general property tax was in trouble. Political leaders and public finance experts realized that the tax did not work so well in a rapidly changing economy. While the state general property tax dominated state finances at the turn of the century its demise was inevitable.

While the uniformity provisions theoretically mandated that all property, including intangibles, be taxed, the reality was much different. Few states taxed any intangible property. Thus, the state general property tax, with its emphasis on real and personal property, no longer reflected the notion of taxing wealth. The general property tax could not deal with the problems resulting from differences between property as a legal term and wealth as an economic concept. Traditionally, wealth in America consisted largely of real property and tangible personal

property. In such an economy, wealth and property are the same things and the ownership of property is closely correlated with income or ability to pay taxes.

In the modern commercial economy that was emerging at that time, ownership and control of wealth was conferred by ownership of a variety of financial and legal instruments such as stocks, bonds, notes, and mortgages. These rights usually did not confer *fee simple* ownership. Local property tax officials, who administrated the tax for the states, lacked the legal authority, skills, and resources needed to assess and collect taxes on such complex systems of property ownership.

Another problem arose from the inability or unwillingness of elected local assessors to value their neighbor's tangible personal property at full value. An assessor who valued property well below its market value and changed values infrequently was much more popular and more apt to be reelected. Finally the increasing number of wage-earners and professional people who had substantial incomes but little property made property ownership a less suitable measure of ability to pay taxes.

The state general property tax presented almost insurmountable enforcement problems. As the country become wealthier, citizens acquired more personal property. No state was able to reach even a small percentage of the total personal property in its jurisdiction. Only a small fraction of such property was ever subject to tax. The primary administrative problem was that citizens became adept at hiding personal property to avoid tax liabilities.

Gradually, lawmakers in states across the nation carved out one exception after another, exempting various sorts of property when they proved difficult to assess. Eventually, these changes left the property tax focused overwhelmingly on real estate; while some states persisted in taxing personal property, especially automobiles, the vast majority of property tax revenue

came from land and buildings. While administratively necessary, the narrowing of the property tax base prompted critics to complain that it now burdened certain types of wealth while letting others escape completely. It seemed a difficult, almost insoluble problem.

In fact, the state general property tax was on such shaky ground that many states began looking for alternative sources of revenue. In 1911 Wisconsin became the first state to tax income. Ten other states would adopt income taxes before the decade ended. In every state part of the motivation to tax income was the lack of faith in the ability of the general property tax to raise sufficient revenue.

### *f. The Reformers*

In 1890, the economic case against the general property tax took a quantum leap forward when economist Edwin Seligman of Columbia University published a landmark attack on "the worst tax known in the civilized world." The levy, he insisted, was devoid of practical or theoretical merit.

It puts a premium on dishonesty and debauches the public conscience. It reduces deception to a system and makes a science of knavery. It presses hardest on those least able to pay. It imposes double taxation on one man and grants entire immunity to the next. In short, the general property tax is so flagrantly inequitable that its retention can be explained only through ignorance or inertia. It is the cause of such crying injustice that its abolition must become the battle cry of every statesman and reformer. (Seligman 1890).

Seligman's sentiments reflected the disrepute into which property taxes had already fallen. The property tax was becoming an object of widespread scorn. Seligman became the intellectual leader of the anti-general property tax movement.

His ire was aimed at the tax on personal property. He surveyed tax studies and found that "Every annual report of the state comptroller and assessors complains bitterly that the assessment of personality is nothing but an incentive to perjury." (quoted in Youngman 1994, 64). He quoted

an 1897 New Jersey report “It is now literally true that the only ones who pay honest taxes on personal property are the estates of decedents, widows, and orphans, idiots and lunatics.” (quoted in Youngman 1994, 64.)

Henry George was another well-known reformer who sought to abolish the general property tax. Unlike Seligman, George is most noted for advocating land taxation. George campaigned across the country for the repeal of the general property tax. He favored replacing the tax (indeed all taxes) with a single tax on land. George wanted an ad valorem tax on the market value of land, but no taxes on improvements to land (buildings, structures) and no taxes on intangible or personal property.

George was often viewed as a radical for his call for a confiscatory tax equal to the full amount of rental value of the unimproved land. Despite that reputation, generations of economists would come to embrace the land tax ideal. Indeed, nearly every Nobel Prize winning economist in the 20th Century endorsed the concept of taxing land. Yet, land taxation never caught on in a meaningful way in the United States.

Those who opposed the general property tax were also encouraged by the newly formed National Tax Association, which from the time of its founding in 1907, was a strong advocate of the abolition of the general property tax. The National Tax Association in its early years repeatedly called for repeal of state property taxes (as “unsound in theory and practice”) and replacement of the lost revenue with personal and corporate income taxes (Fisher 1996). The organization had a significant effect on fiscal policy in the early 20th Century.

### ***g. The Great Depression and the End to the General Property Tax***

While the state general property tax was under constant pressure during the first decades of the 20th Century, it was the Great Depression that ultimately ended the tax. The Great

Depression not only led to the demise of the general property tax, but effectively ended state reliance on property taxes in general. Real property values declined significantly when the economy collapsed in 1929. The resulting fall in property tax revenue was so great that states were forced to find alternative means of finance. Increasingly, states turned to income and sales taxation as a means of raising revenue. And every state that adopted income and/or sales taxes during that time period completely repealed or seriously curtailed their property taxes.

The percentage of total revenue raised from the general property tax declined steadily, taking its most precipitous drop between 1922 and 1942 as property values declined during the Depression and states adopted sales and income taxes. Table 2 illustrates the decline in state reliance on property taxes.

**Table 2.** Property Taxes as a Percentage of Own-Source General Revenue, Selected Years

<i>Year</i>	<i>State</i>
1902	45.3
1913	38.9
1922	30.9
1932	15.2
1942	6.2
1952	3.4
1962	2.7
1972	1.8
1982	1.5
1992	1.7
2002	1.6

Source: U. S. Census of Governments, Historical Statistics of State and Local Finance, 1902-1953; U. S. Census of Governments, Governments Finances for (various years);

### ***h. The First Tax Revolts***

Many people would be surprised to learn that the first property tax revolt was not California's Proposition 13, but rather those that occurred during the Great Depression. Real income fell by 33 percent by 1932 and the unemployment rate soared to 25 percent. The under- and unemployed were still faced with paying their property taxes. While property values (and hence property tax burdens) were falling, the dramatic loss of income forced many homeowners into or near bankruptcy. Real estate values fell by 92 percent (Beito 1989). Tax assessments did not fall nearly as far or as fast. Moreover, the share of income absorbed by the property tax doubled between 1929 and 1932 reaching 11.3 percent (O'Sullivan 2000).

While states were quickly adopting income and sales taxes to replace lost property tax revenue, local governments remained heavily dependent on the property tax. In 1932, for example, property taxes accounted for 85.2 percent of local government own source revenue. The high level of property taxation at the local level was the result of massive growth of municipal government during the 1920s. American cities grew rapidly in terms of both population and budgets. The increased services, particularly for public works projects were funded by debt and property taxes. For cities over 30,000 population, property taxes accounted for 90 percent of total revenue (Beito 1989).

The crash of 1929 produced an upsurge in tax delinquencies, bankruptcies, and foreclosures. Nationwide, localities had property tax delinquency rates of over 26 percent (O'Sullivan 2000). In some cities, the delinquency rates were much higher. Shreveport, Louisiana had a delinquency rate of 68 percent (Beito 1989). The sheer volume of delinquencies and the threat of losing homes gave rise to the most serious tax revolts in America since the Whiskey Rebellion.

As early as 1930, unhappiness with property tax burdens -- which were not receding -- caused a storm of protest across the country. Thousands of taxpayer organizations, all created specifically to fight for property tax relief, were formed. Tax protestors marched on city halls and held parades. They accosted political leaders demanding property tax relief. They began running candidates for office, often on radical platforms that called for significant reductions in tax revenue and spending. In many parts of the country, protestors confronted government officials -- sometimes violently-- at tax sales. The tax protestors threatened to withhold payment of taxes.

Eventually, the protests subsided as citizens realized that essential government services could not be provided if property tax revenue was not raised. The connection between government services and tax liabilities was made clear by public “pay your taxes” campaigns. These campaigns were financed by coalitions of business, community, and political leaders who feared anarchy in the streets if government services were shut down. The establishment of the Home Owners Loan Corporation (HOLC) by the federal government in 1933 suppressed the public anger over property taxes. The HOLC loaned money to homeowners to pay back property taxes. Between 1933 and 1935, HOLC lent over \$200 million (Beito 1989).

The tax protests of the 1930s had significant repercussions. In 1932 and 1933 sixteen states and numerous localities some form of limitations on property taxation (O’Sullivan 2000). Throughout the depression states began to limit local property taxation. Michigan, Nevada, Ohio, Oklahoma all placed statutory or constitutional limits on property tax rates during the early years of the Great Depression. West Virginia and Washington would later place limits on rates.

But the major lasting property tax consequences of the Great Depression and the tax revolts were the implementation of homestead exemption and credit programs. During the Great

Depression, virtually every state adopted some form of homestead exemption to give poor homeowners relief and help them avoid foreclosure. The homestead exemptions granted during that time were available to all homeowners. In 1957 New Jersey enacted the first exemption targeted to senior citizens. Since that time, 24 states have adopted homestead exemptions that provide more generous relief to the elderly.

### ***i. Post War Property Taxation***

After the Great Depression and World War II, the property tax was almost exclusively a local revenue source. The states continued to raise small amounts of revenue from taxing property, but the overwhelmingly majority of the property tax dollars found their way into local budgets. Local governments had taxed property since the beginning of the nation. Indeed, while data is largely unavailable from the 19th Century, it is widely assumed that the property tax was the primary source of revenue for local governments throughout American history. Moreover, local governments administered and collected the general property tax for the states.

In the post war years, the tax became almost exclusively imposed on real estate. The three decades after the World War II were times of rapidly increasing real estate values across the country. With money readily available, local governments witnessed an explosion of growth during this time.

Interestingly, while property tax revenue continued to grow at a rapid pace, it did not grow as a percentage of local tax revenue. In fact, the property continued to fall as a percentage during most of the 20th Century. This was largely a testament to the revenue needs of local governments which to satisfy citizen public service demands turned to other revenue sources (primarily local option sales taxes) as well as increased federal and state intergovernmental aid. See Table 3.

**Table 3. Property Taxes as a Percentage of Own-Source Local Government Revenue, Selected Years**

<i>Year</i>	<i>Local</i>
1902	78.2
1913	77.4
1922	83.9
1932	85.2
1942	80.8
1952	71.0
1962	69.0
1972	63.5
1982	48.0
1992	48.1
2002	43.6

*Source:* U. S. Census of Governments, *Historical Statistics of State and Local Finance, 1902-1953*; U. S. Census of Governments, *Governments Finances for (various years)*;

While the amount of property tax revenue fell as a percentage of total own source revenue, the tax remained the most dominant single source of revenue for local governments. From 1902 to the present day, no other source of revenue came close to matching the amount of money raised by local governments from the property tax (Brunori 2003).

But with the success of the tax, many of the inherent problems with taxing property became obvious to citizens and policy makers. Consistently rising real estate values increased tax burdens virtually every year during the 20th Century. The property tax was particularly worrisome for senior citizens many of whom lived on fixed incomes. In many parts of the United States property values were rising much faster than inflation. While nearly every state offered homestead exemptions, the rising tax liabilities put considerable pressure on citizens. In response, a new wave of property tax limitations was imposed during the 1960s and 1970s.

In the 1960s states began adopting circuit breakers. Circuit breakers are targeted relief programs designed to provide assistance to those who need it most. Typically, the state grants an income credit (often refundable) to low and middle income property owners once their property tax burdens reach a certain percentage of their income. The first circuit breaker program was adopted in Wisconsin in 1964. Four other states implemented circuit breakers in the 1960s and 25 more between 1970 and 1979.

But even circuit breakers were not enough to quell the public's unhappiness with rising property tax burdens. In 1976 seven states placed limits on property tax rates. In that same year, nine states placed limits on property tax revenue growth. These measures forced local governments to roll back tax rates or assessments if property tax revenue grew faster than a legislatively determined rate.

### ***j. Proposition 13 and the Modern Tax Revolt***

The various property tax relief measures adopted in the 1960s and 1970s failed to change the public's attitudes with respect to the tax. The public by and large still disliked property taxes. That dislike combined with a growing cynicism and distrust of government to lead to the most significant development in American property tax history -- the tax revolts of the late 1970s and early 1980s.

Proposition 13 and its progeny not only dramatically changed property taxation but also were a defining moment in the public's attitudes toward taxation in general in the United States. The tax revolts changed the way many local governments raised revenue. But they also signaled the beginning of a new and decidedly anti-tax political philosophy that continues to this day.

*i. California Proposition 13*

The causes of Proposition 13 were varied. The public was frustrated by continuously rising property tax burdens. California real estate values were increasing 25 percent a year in the decade before passage of Proposition 13. The public was equally frustrated with local government leaders that refused to lower tax rates and state government leaders who refused to offer relief. In the years leading up to Proposition 13, the state of California enjoyed multibillion budget surpluses. Political leaders around the state were aware of the property tax problem for at least a decade before 1978. Governor Ronald Reagan proposed limiting property taxes in 1973. Los Angeles County assessor Phil Watson led two property tax limitation drives in 1968 and 1972. These efforts were unsuccessful and the California legislature refused to provide property tax relief for four straight years before the proposition passed.

Another cause for Proposition 13, and indeed other property tax protests, was school finance litigation. In 1972, the California Supreme Court held that the system of financing education through local property taxes was unconstitutional. The court ordered that the state assume the primary role in financing the schools. That decision had the effect of diminishing public support for property taxes and is arguably one of the reasons for the public's willingness to approve Proposition 13 (Fischel 1989).

Howard Jarvis took advantage of the public's decidedly anti-property tax mood and mobilized a campaign to pass Proposition 13. On June 2, 1978, two thirds of California voters chose to radically reduce and limit property taxes in the state. Proposition 13 rolled back assessment values to 1976 levels. It limited increases in assessed value to two percent a year as long as the property was not sold. It imposed a one percent limit on the property tax rate. The measure also required that all state tax increases be approved by a two-thirds vote of the legislature and that all local tax increases be approved by a vote of the electorate.

The effective was dramatic. Property tax revenue immediately fell by 57 percent across the state. Local governments in California collected over \$6.6 billion less in property tax revenue in 1979 than they did in 1978 (Citrin 1984). California property taxes went from being 51 percent above the national average in 1978 to being 22 percent below the average in 1981.

California local governments became much more dependent on state aid as a result of Proposition 13. They also began significantly increasing user fees and charges (which were not subject to limitation). Between 1978 and 1981, local government user fee revenue increased by 48 percent; and Los Angeles increased user fee revenue by 67 percent (Richter 1984)<sup>3</sup>.

### *ii. Idaho*

Less than six months after the passage of Proposition 13, Idaho voters had the opportunity to decide the fate of their property tax system. Idaho was not a likely candidate for a tax revolt. The state enjoyed a relatively low property tax burden. But in the preceding decade, property tax liabilities rose sharply particularly for residential owners. The Idaho Supreme Court had forbidden the use of separate assessment ratios for residential property and the homeowners' share of the property tax burden had rise from 24.5 percent in 1969 to 44.5 percent in 1978 (Citrin 1984). In November 1978, Idaho voters overwhelmingly approved a one percent property tax rate limit, as well as a limit on assessment increases of two percent a year.

### *iii. Massachusetts Proposition 2 1/2*

That Massachusetts would follow California in the property tax revolt is not surprising. In 1980, Massachusetts had the highest effective property tax rates on single family homes and the highest property tax rates as a percentage of state personal income. Efforts during the 1970s to provide property tax relief repeatedly failed.

Proposition 2 1/2 passed in November 1980 with 59 percent of the vote. The measure limited the tax levy for each city and town to 2.5 percent of the assessed value. It also limited the growth of property tax revenue to no more than 2.5 percent a year. Within a year, property tax revenue fell 9.5 percent or \$311 million (O'Sullivan 2000). Property tax revenue in Boston alone fell by 75 percent during that time.

*iv. The Legacy of Proposition 13*

The immediate impact of Proposition 13 was significant. Within six months after passage of Proposition 13, tax limitation measures were on the ballots in 17 states and all but five were approved. There were 58 ballot measures during the 1979-84 period concerning property tax classification, exemptions, assessment reform, and rollbacks. Among the most successful were tax and expenditure control measures. Forty-three states adopted new property tax limitations or relief plans between 1978 and 1980. Idaho and Massachusetts followed California's lead and adopted measures that both cut and limited property taxes. New state spending limits were set in New Jersey and Colorado. Several states tied growth in local government spending or revenue to growth in personal income or population. Michigan restricted growth in local property tax revenues to the rate of inflation, and state revenues were limited to the share of personal income they represented in 1978-79.

Although the tax revolt movement lost momentum in the latter half of the 1980s, continued dislike of the property tax together with the fiscal pressures resulting from the recent recession have served to maintain interest in changing the tax and spending activities of state and local governments.

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<sup>3</sup> For in-depth histories of Proposition 13 see Kuttner (1980), Smith (1998), and Ring (1984).

## 2. National Trends in Property Taxation

The dollar value of total property tax collections has increased dramatically over the past fifty years. As illustrated in Table 4 below, total state and local property tax collections rose from just over \$9 billion in 1953 to nearly \$300 billion in 2002 – the largest single source of revenue for state and local governments. Indeed, the property tax revenue approximately doubled every decade during this time period. Remarkably, the tremendous growth in property tax revenue occurred even during the 1980s and 1990s – a time of widespread adoption of tax limitations in most states.

**Table 4. Property Tax Revenue  
Collected by State and Local Government, 1953-2002**

<i>Year</i>	<i>Total State and Local Property Tax Revenue</i>	<i>Per Capita</i>	<i>Percentage of Personal Income</i>
1953	\$9,381,041	\$80.85	3.24%
1962	\$19,054,286	\$102.59	4.19%
1972	\$42,877,189	\$204.90	4.34%
1982	\$82,067,442	\$354.25	2.97%
1992	\$180,336,841	\$706.98	3.75%
2002	\$279,121,680	\$991.79	3.14%

The growth in property tax revenue is also illustrated by the changes in per capita collections. Data in Table 4 show that in 1953, state and local property taxes raised approximately \$80 per person. The per capita amount rose to \$205 in 1972 and totaled \$990 per capita by 2002.

The nominal growth in property tax revenue during the half century at issue is attributable to a number of factors. The primary cause for the growth is steadily increasing property values. The magnitude of the appreciation of real property values overshadowed

attempts to limit tax growth. Another factor contributing to property tax revenue growth is that the tax has remained the dominant source of revenue for local governments. Despite political problems and general unhappiness with the tax and a shrinking tax base, there are no viable alternatives to financing local government (see Brunori 2001).

While the amount of property tax revenue and the per capita collections grew dramatically, the property tax did not grow as a percentage of personal income. As shown in Table 4, in 1953, the property tax accounted for 3.24 percent of personal income. In 1980 the tax accounted for 3 percent of personal income and in 2002, the tax still accounted for only 3.1 percent of personal income. So while there has been significant growth in the amount of property tax collected, that growth is not reflected in terms of an increasing share of personal income. Indeed, it is arguable that the tax has not increased at all in terms of how it affects citizens. That the tax is still taking the same amount relative to income from the citizens has not lessened the public's unhappiness, however.

Perhaps the most dramatic change in terms of property taxation has been the role of the tax in the state and local fiscal system. Despite the growth in the amount of property tax collected, the tax's role in financing state and local government has fallen sharply over the past five decades. The data in Table 5 show that in 1953, the property tax accounted for just over 34 percent of total state and local general revenue. Since that time, the reliance on the property tax has fallen significantly. In 1972, the property tax had fallen to 13.91 percent of state and local general revenue. By 2002, property tax revenue grew in relation to other sources of revenue but still accounted for only 16.6 percent of state and local general revenue.

**Table 5. Property Tax as a Percentage of State and Local General Revenue**

<i>Year</i>	<i>Percentage</i>
1953	34.35%
1962	32.71%
1972	13.91%
1982	9.47%
1992	18.42%
2002	16.57%

There are a number of likely reasons for this decline. Taxpayer political unhappiness has kept reliance on the property tax in check. Political leaders have been hesitant to increase property tax rates. The property tax limitations implemented in the past three decades have significantly curbed revenue growth relative to the actual value of real property in the United States. In terms of its relative importance, the property tax fell as a percentage of total revenue in part because several large states adopted income taxes during this time,<sup>4</sup> providing additional sources of revenue.

The property tax has been declining as a share of total local tax revenues over the last 50 years. This reflects, in part, a shift toward local sales and income taxes. Such a shift toward other taxes undermines the stability and fairness of the local tax system. For example, property taxes are less sensitive to economic cycles than income or sales taxes. As such, a shift away from the property tax undermines the stability of the local revenue system because sales and income taxes vary with activity levels in the overall economy. The budgetary pressures faced by local governments after the extremely mild recession of 2000 to 2001 illustrate this vulnerability.

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<sup>4</sup> Pennsylvania, Rhode Island, and Ohio enacted income tax laws in 1971, New Jersey in 1976, and Connecticut in 1991.

Similarly, the property tax is consistent with the ability to pay criteria for local taxes. This is especially true in an environment where home ownership rates are 65 percent or higher.

A shift from the property tax to the local sales tax undermines equity because of the increasingly narrow base of the sales tax and the regressivity of the tax. Finally, the property tax is consistent with the benefits received principle of taxation. This promotes accountability at the local government by aligning benefits received with taxes paid. A movement to de-emphasize the property tax by increasing reliance on income or sales taxes undermines such accountability because of the lack of linkage between benefits received and taxes paid.

## **B. POLICY ISSUES**

### **1. Strengths of Property Taxation**

The virtues of the tax that have given rise to its importance have been long recognized by public finance scholars. The tax has been praised by the intellectual leaders in the public finance field as the ideal source of revenue for local governments. (See e.g., Harris (1974); Musgrave (1983); Oates (1999); Bird (1993); Netzer (1966); Bahl (2001); Break (1993) and Youngman (1998). And there is virtual unanimity amongst these and other scholars as to the virtues of the tax.

That leading scholars have touted the virtues of the property tax has led to widespread endorsement of the tax by public finance professionals. Slemrod (1995) reported, for example, that 93 percent of the membership of the National Tax Association favored the use of property taxes to fund local government operations. Set forth below are the primary reasons for the success of the tax.

*a. An old tax*

As noted above, there are few older taxes than those on property. The property tax remains an important source of revenue for local governments in large part because it has always played that role. While such a statement may seem tautological, there is an argument to be made that society's long term reliance on the property tax is a normative good. After all, the fundamentals of a tax system (particularly the underlying base) should change infrequently (National Conference of State Legislatures 1992). Changing tax systems, even in small increments, create administrative and compliance costs. And more importantly perhaps, significant changes disrupt settled expectations as to what is and what is not taxable.

For more than two hundred years local governments have relied on the tax to fund public services. Indeed, the earliest evidence of property taxes in America occurred nearly 130 years before the Declaration of Independence. Since that time, the property tax has played the dominant role in financing local governments.

The historical dominance of the property tax was attributable in part to the fact that local governments for much of America's existence did not play as extensive a role in providing public services that they do today. Local governments have long provided basic public safety and transportation services. But they did so on a much smaller scale. And public education did not become a widespread local government function until the late 19th Century. Simply, local governments did not spend as much money in 1850 as they did in 1950. Thus, the property tax proved more than adequate to fund the limited local government services offered throughout the early period of American history.

Moreover, the historical dominance of the tax was attributable to the fact that there were no alternatives to financing local government. General sales taxes were not implemented in the

United States until the onset of the Great Depression, and then initially only at the state level. Income taxes were instituted nearly a generation before that by the federal and state governments, but at the time of their inception, there was never discussion or debate to impose taxes on income by local governments. Excise taxes were largely the purview of the federal and state governments and the age of the user fee and charge was hardly imagined by local political leaders.

At the start of the 21st Century, virtually all American property owners viewed the property tax as a fact of life. Americans may not, indeed by all accounts do not, like property taxes. But they have come to accept it as the way local government is financed. Certainly, few property owners are surprised when the property tax bill arrives --because it always arrives.

***b. Stability***

The property tax has long provided a stable and reliable source of revenue for local governments (Mikesell 1993, 34; Shuford and Young 2000, Sheffrin 1999). Stability and reliability have long been thought as requirements for creating a sound tax system (NCSL 1997, 7). And there are few taxes more reliable than those on real property. Local governments rely on the tax because, unlike all other local option taxes, the base of the tax cannot, for all intents and purposes, be moved. The revenue from such a "captive" tax base can be relied upon to a greater extent than either wage or sales taxes -- both of which have highly mobile tax bases. Local officials can budget for public services knowing that the underlying base will be available to support those services.

It is another principle of sound taxation that a tax system must not only provide for current spending, but also be capable of meeting the future revenue needs of the local jurisdiction (NCSL 1992). As public finance experts recognize, the property tax revenue has consistently

grown over the years. It has even grown dramatically in real dollars between 1980 and 1997, a time during which significant limitations were placed on property tax rates and assessed values. Property tax revenue growth has much to do with the fact that real property values appreciate over time. And because real property appreciates over time, property tax revenues continuously grow. Thus, the property tax is uniquely positioned to meet future public service needs.

As importantly, from a political perspective, the property tax revenue grows without the risks associated with raising rates. Political leaders, while often decrying the property tax, appreciate the tax in no small manner. Property tax rates are rarely raised to meet the public service demands of the citizens. Indeed, property tax revenue often grows faster than the public service demands of local citizens. This phenomenon is not necessarily an unqualified normative good.

In any event, the steady growth of property tax revenue and the immobility of the tax base provide local governments much more flexibility with respect to their fiscal systems. As revenue naturally grows, local officials have the ability to adjust the level of services and tax burdens according to the desires of their constituents. The property tax is the principle source of fiscal flexibility for local government a view recognized by public finance scholars (Sokolow 1998).

That flexibility enhances local taxing authority, which in turn strengthens local government political autonomy. That flexibility also affects the efficiency of local governments. The ability to adjust services and burdens to match the demands of the public is dependent upon a flexible source of tax revenue. The property tax has provided that flexibility and arguably enhanced the ability of local governments to operate in an efficient manner.

*c. Compliance and Administration*

Although not without problems<sup>5</sup>, administration and compliance with the property tax is relatively easy and thus inexpensive (Sheffrin 1999). This is because the underlying tax base -- the land or improvements thereto -- is immobile. For government, the tax base is easily identifiable. And while values change, the number of acres, parcels, and buildings are easily ascertainable by most local government administrators.

Another virtue from the government's perspective is that taxpayers cannot easily hide or move property. Thus, unlike income and sales taxes the property tax is difficult, indeed virtually impossible, to evade. Moreover, the property provides collateral for the tax liability. If the property owner fails to pay the taxes a lien is placed on the property. That lien prevents the property from being sold or mortgaged until the tax liability is satisfied. If collection efforts are unsuccessful, the local government can seize and sell the property. The local government retains the taxes owed, penalties, interests, and administrative costs, and remits the remainder to the owner. While property tax sales are often the last resort for local governments, such sales provide powerful incentives to comply with the law. That the property tax is difficult to evade is a clear advantage for government officials charged with its administration. But this attribute appeals to citizens who routinely pay their tax liabilities, i.e., honest taxpayers. Tax evasion, after all, raises the burden of paying for government for all taxpayers.

The tax presents equally attractive compliance benefits for the taxpayer. Most residential property owners face minimal compliance costs. Unlike the much more onerous (from a compliance standpoint) federal and state income taxes, there are no forms to file when

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<sup>5</sup> The administrative problems with the property tax are usually linked to valuation issues (Lowery 1982; Bowman and Mikesell 1978; Kidd 2002; Youngman 1998, and see Walters, et.al. 1995 for a discussion of

complying with property taxes. There are generally no calculations to be made. Indeed, the property tax is calculated by the government and the taxpayer's role begins and ends when the tax is paid. And it is rare for an individual property owner to incur fees for professional tax assistance (i.e., accountants, attorneys) when complying with the property tax. The property tax is rivaled only by the sales tax in terms of compliance burdens, or lack thereof, for individual taxpayers.

State and local governments provide a plethora of exemptions and credits to provide property tax relief to poor homeowners, the elderly, disabled, and veterans. Such tax benefits certainly increase the compliance costs for individuals, as well as the administrative costs for government. But these benefits have proven not to be particularly onerous to the recipients.

The property tax when applied to commercial and industrial property offers more challenges and costs to government and taxpayers alike (Strauss 2001). Commercial property is often unique and thus presents administrative problems particularly with respect to valuation. Local government spends more resources ascertaining commercial property values than they do in determining residential values.

Moreover, commercial property owners generally face significantly higher property tax burdens than residential property owners. Because there is more at stake, businesses have greater incentive to insure proper assessment of values. Commercial property owners also have the resources to challenge assessments, a fact that makes administering the tax more expensive on the part of the government. The increased administrative and compliance costs of taxing commercial property, as well as the distorting effects on investment, has led to calls for limiting the property tax to residential property (see e.g., Break 1980). But taxation of commercial and

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the significant problems regarding property tax administration of public utilities).

industrial property is politically attractive -- and thus likely to continue -- because officials and the public view the business taxes as "victimless" because they fall on corporations or are exported (Youngman 1999).

In any event, overall the local property tax presents few administrative and compliance burdens, particularly with respect to residential property. Indeed, it is arguably the most efficient tax in terms of administration as 96 percent of the total tax is collected annually, an amount far higher than any other type of tax revenue (Shuford and Young 2000). As Fischer (1989, 123) noted, "A symbiotic relationship between taxation and structure of government exists in the United States. The property tax has evolved into a form well suited to financing of small, overlapping units of government with varying functional responsibilities. Other forms of revenue require greater administrative cooperation or involve varying degrees of control by higher levels of government."

#### ***d. A Benefits Tax***

The property tax has endured because it is conceptually attractive. As opposed to state sales and income taxes, property tax revenue is raised locally to support local public services. There was, and remains, a connection between the source of the revenue -- the property -- and the services being provided (Bird 1993). That connection arises because the services provided by local governments benefit the owners and renters of the property within the jurisdiction. The property, the taxes, and the services are all linked. That is why local governments pursue policies that protect and increase the value of property located in their jurisdictions, particularly the value of residential property. The quality of public services is directly related to property values (Fischel 2001).

But, one need not read the extensive academic literature on this subject to understand the connection. A citizen's most valuable asset is usually his or her home. The citizen's wealth increases as the value of the home increases. Quality police and fire protection, paved roads, and schools that score well on standardized tests all contribute to the value of the home. People desire to live in communities that offer quality public services. The resulting demand for such services increases property values in the jurisdiction providing the services.

The beneficiary of the public services is the property owner, and under the benefit principle of taxation it is the property owner who should be paying for the services. To the extent the property tax is used to fund local government, i.e., to provide services to those who pay for them, it must be considered a benefit tax (Fischel 2001). Essentially, the property tax can be viewed as the cost of receiving local government services. The tax cost reflects the value of the services (i.e., benefits) received.

Benefit taxes are the most efficient and effective means of financing local government. That the property tax is a benefits tax -- and thus particularly well suited for financing local government -- has been recognized by many leading economists. (Netzer (2001); Break (1995); Bird (1993); and Fischel (2001). One of most astute observers of local public finance stated, "Local property taxation, in conjunction with local zoning ordinances, produce what is in effect a system of benefit taxation that promotes efficient local and fiscal decisions on the part of households" (Oates 1999, 68).

But not everyone agrees with this view of property taxation. There are economists who believe that the property tax is a tax on capital and as such can have a progressive or redistributive effect. This position is often called the "new view". There is a lively, and long running, debate over whether the property tax burdens are borne by consumers through higher

housing prices and thus regressive (Netzer 1966), are actually progressive taxes on capital (Mieszkowski and Zodrow 1989)<sup>6</sup>, or are in fact non-distortionary benefit taxes (Fischel 2001, Hamilton 1975). See Ladd (1998), for a review of the extensive literature in this subject.

The question is more than an academic exercise. If the benefit view is correct, then the anti-property-tax movement may be destructive, because under this view, the property tax is an integral component of an efficient local public finance sector. On the other hand, if the new view is correct, then the property tax is a tax on capital -- and not necessarily a good thing. Under the new view the anti-property-tax movement can be justified on efficiency grounds. But debate centers on the effects and incidence of the property tax on the national economy. That is, nationally, the property tax may have a progressive effect. But even adherents to this school of thought recognize that at the local level, property owners will bear the full burden of tax increases -- as one would expect under the benefit view (Zodrow 2001, 144).<sup>7</sup>

In any event, the connection between property taxes and local government services cannot be denied. The American public recognizes this connection and is willing to pay property taxes to support local public services that it desires.

### *e. Local Autonomy*

Economist Harold Graves (1948) once noted that "the virtue of the property tax was that it was the best available independent source of local revenue and made it possible for citizens to spend their own money as they collectively saw fit." Indeed one study led researchers to

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<sup>6</sup> See also Aaron (1975) who argued that owners of capital bore the burden of property taxes, which rendered the tax progressive.

<sup>7</sup> As important as this ongoing academic debate, is the political perception that the property tax is "regressive." Youngman (2002) shows that political leaders and the media routinely characterize the property tax as regressive, when they actually intend to say unfair or unpopular. As Youngman (2002)

conclude that local fiscal autonomy is a direct result of reliance on property taxes (Shuford and Young 2000).

The property tax traditionally has allowed local constituencies to control their financial matters (Harris 1974; Knapp 1999). The property tax is the one source of revenue that does not have to be legislated, administered, or collected by the state or federal governments. The property tax has been successful because for the last century it has been used almost exclusively by local governments.

Indeed, the property tax arguably cannot be efficiently administered by central governments. Attempts to adopt statewide property taxes have been rejected or, when implemented, have caused significant political controversy (Brunori 2001). This stems from the fact that while the property tax is at least tolerated as a local benefit tax, it is largely thought unworkable as a means of redistributing income (Brunori 1999).<sup>8</sup>

It has long been recognized that the more levels of government that impose a tax on the same base, the less control all effected governments have on the tax. When multiple levels of government tax income for example, it becomes politically difficult for any level of government to increase rates because the overall income tax burden is already high. When multiple levels of government impose a tax on the same base, altering that base makes the system much more complicated. In the United States, the federal government has traditionally relied on income taxes, while the states have traditionally relied on a combination of income and consumption taxes. But local governments, except for the largest cities, have relied almost exclusively on property taxes.

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noted the political perception is not justified on economic grounds.

<sup>8</sup> Vermont and New Hampshire for example impose statewide real property taxes to fund public school

The property tax has been successful in part because neither the federal nor state governments tax real property. Thus, theoretically, local governments should have greater flexibility with respect to the property tax system.

*f. Visibility*

Another, albeit less discussed, virtue of the property tax is its visibility to the public in general and to taxpayers in particular. Visibility is a characteristic of a sound tax system because it insures accountability (Bird 1993). Unlike sales taxes (paid in small increments to the vendor) or income taxes (generally withheld from employers) the property tax is usually paid in a lump sum to the government. Those who pay directly to the government are more aware of the size of their tax burden than those who pay taxes through intermediaries. There is little doubt that the property tax is among the most, and probably the most, visible of taxes encountered by American citizens. Property owners get a bill, at times a large bill, on an annual or biannual basis.

This awareness provides citizens the opportunity to evaluate whether their tax dollars are paying for services they want and need. This evaluative process is critical if local governments are to operate efficiently. Tiebout assumed that citizens and firms would have information about the tax and service levels of competing local governments. But more critical to the analysis is that citizens need to have accurate information as to the tax costs of their own government. It is fundamental to democratic governance that citizens know how much tax they pay. The property tax, with its high visibility, provides that information better than any other revenue source with the exception of, perhaps, user fees and charges.

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finance. Those policies have resulted in intense political controversy (Brunori 2001).

The high visibility of the property tax is also the cause of much discontent. Citizens have long disliked the tax, in comparison to other levies, precisely because it is highly visible. Still, despite the political consequences of high visibility, the tax allows citizens to evaluate the costs of their government. And by any measure, that is considered a sound policy objective.

## **2. Problems with the Property Tax**

### ***a. Political Issues and Public Unhappiness with the Property Tax***

It has now become part of public finance lore that the property tax is the "worst tax." It certainly is among the most disliked of taxes. During the latter half the 20th Century, the Advisory Commission on Intergovernmental Relations (ACIR) conducted an annual public opinion poll to gauge views on the federal, state, and local tax systems. One of the most cited aspects of the poll was the request for people to identify the tax that they dislike the most. Over the course of the ACIR polling, the property tax was annually listed as the worst tax or the second worst tax following the federal income tax.

Despite the positive attributes discussed above, there are several reasons why the public has grown to dislike the property tax so much.

#### ***i. Visibility***

The tax is disliked because of its high visibility. By all accounts the property tax is the most visible of all taxes paid by property owners in the United States. The tax is imposed on a yearly basis. And once or twice a year the property owner receives a bill from the city or county. The amount due is usually more than any single tax payment the property owner has to pay.<sup>9</sup>

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<sup>9</sup> For property owners who pay the tax as part of their mortgage, the property tax is less visible. The amount provided to the mortgage holder is higher because of the tax liability, but the amount dedicated to

This "sticker shock" has contributed to the public's unhappiness with the tax. It is not surprising then, when opinion polls are conducted to find the least favorite tax, the public has consistently listed the two most visible, the property tax and the federal income tax.

Moreover, unlike the sales tax, property tax liability is not triggered by a voluntary act of the taxpayer. It arises from the mere ownership of real property. Unlike income taxes, the government demands payment even though there may be no additional income from which to pay the tax. And, unlike sales taxes, collected in small amounts from vendors, or income taxes, usually withheld, the government actually makes a demand for payment (Youngman 1999).

Visibility is considered a virtue in a sound tax system. Visibility means that citizens can explicitly ascertain the costs of government. Ironically, while contributing to the public's dislike, the high visibility has helped make the local government system efficient. The ability to determine whether the government is providing the desired mix of taxes and services requires that citizens understand their tax burdens. A property tax certainly performs that function. Yet the high visibility has led directly to the unpopularity of the tax, a fact not lost on most public finance experts (Youngman 1999).

### *ii. Unfair Administration*

The administration of the property tax has also led to public displeasure. In general, property should be assessed on its market value, which is defined as what a willing buyer would pay a willing seller. More importantly, all similarly situated property should bear the same relative tax burden. Such horizontal equity is critical to sound tax policy. Imposing different tax

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taxes is not readily apparent. This is one reason why the elderly, who are less likely to have mortgaged property, are more opposed to property taxes.

burdens on similarly situated taxpayers leads to distrust of the tax system and government (Brunori 2001).

In reality however there are many discrepancies between the assessed and market value of property. In fact, many local governments have, traditionally, failed to meet legal requirements to maintain current market through timely reassessment of property. The result is that for many taxpayers, property values are overstated for tax purposes. There is little doubt that similarly situated properties with similar market values have been assessed and taxed differently (Strauss 2001). And this dissimilar treatment has contributed to unhappiness with the property tax.

The problems associated with uneven valuations are heightened because property tax records are public documents and available for inspection. Thus, property owners can ascertain and compare the assessed value of their neighbor's property. Moreover, that property tax assessments are often inaccurate is well known, reported in the press, in academia, and before government agencies. Despite great improvements in the accuracy of valuation practices over the past quarter century, the perceived unfairness of the system persists.

### *iii. Shifting Burdens*

The public's unhappiness with the property tax has been arguably magnified by the shift of property tax burdens from commercial and industrial real estate to residential real estate. Homeowners are bearing a larger share of the property tax burden than ever before (Green, Chevrin, and Lippard 2002). There are several reasons for this phenomenon. Strauss (2001) set forth four causes for the shifting burdens: 1) taxes on many types of business property are difficult to administer; 2) federal tax policy has encouraged investment in equipment rather than

plant; 3) homeownership and home values have increased; and 4) economic downturns have kept commercial and industrial property values relatively low.

To this list, one might add, the proliferation of tax incentives to foster economic development. These incentives, which usually involve property taxes, shift the burden of paying for local government away from business toward homeowners.<sup>10</sup>

The result of this shift in tax burdens has been an increase in the relative amount of property taxes paid by individual property owners, particularly homeowners. The increased tax burdens have not been accompanied by increased or improved public services. The increased tax burden on homeowners, according to Strauss (1997), has led directly to increased public unhappiness with the property tax.

#### *iv. Public Unhappiness and Its Consequences*

The effects of the public's unhappiness have been dramatic in terms of limitations on the role of property taxes in local government finance system. As discussed below, the public's displeasure directly led to the property tax revolts of the 1970s and 1980s that resulted in significant statutory and constitutional limitations on the property tax. But even apart from the legal limitations placed upon the tax, the public's unhappiness has created a strong political bias against the tax.

The ACIR polling results have been cited repeatedly in both the general press and academic writing for years. Indeed, that the property tax is the worst tax is almost a given in public policy discussions regarding local taxation. This in turn has led many political leaders to seize upon these public perceptions and call for further reductions in the tax. There is no doubt

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<sup>10</sup> And one might also add the changing economy, which has placed a greater emphasis on intangible property than on traditional plant and heavy equipment (Strauss 1997).

that political leaders, particularly at the state level, have taken a negative view of the property tax. One poll showed that fifty percent of all state legislators think the property tax is unfair (Beamer 2000, 103). A review of news articles published in *State Tax Notes* magazine from January to July 2002, shows at least 50 instances in which state political leaders have called for additional limitations on, or outright elimination of, the property tax. Logically, such political views facilitate policies designed to limit the property tax

*i. Tax Limitations*

Perhaps the main reason for the decline of the property tax as a source of local revenue has been the myriad of constitutional and statutory limitations placed on the tax, especially during the past quarter century. The property tax revolts that began in the late 1970s wreaked havoc on the tax. As of 2002, 44 states have some restrictions on the ability of local governments to impose property taxes. And in 33 of those states, those restrictions are substantial -- resulting in property tax revenue declines of 15 percent or more since their inception. The initiative process, which arose in part out of citizen unhappiness with the tax, spawned many of the limitations; 58 different ballot initiatives aimed at reducing property taxes went to the voters between 1979 and 1984 (Sexton and Sheffrin 1995).

The limitations on the property tax take several forms. For example, 33 states have imposed property tax rate limitations. These laws prohibit the imposition of rates over a predetermined level. The most notable rate limitation was established in California by Proposition 13, and set the maximum property tax rate at one percent. Rate limitations obviously inhibit the use of the property tax to increase revenue by raising rates. In this respect rate limitations clearly undercut the ability of local governments to establish their own levels of revenue, which in turn restrict their ability to set spending levels.

Twenty-seven states impose property tax revenue limits. These laws prohibit property tax revenue increases from rising above certain levels. Property tax revenue limitations take two forms. Some states require property tax rates to be reduced if property tax revenue exceeds a certain amount. And some states require that property tax assessments be reduced when revenue increases extend beyond the limits.

Property tax revenue limits have an obvious effect on local government fiscal autonomy. The property tax cannot be used to fund increased public service costs, even if those costs rise due to nothing more than inflation. The effect on local government fiscal autonomy is somewhat mitigated by the fact that in fifteen states, the limitations can be over ridden by a vote of the citizens.

Another six states impose limitations on increases of assessed property values. These limitations prevent the annual property valuation from increasing beyond the established constitutional or statutory limit. For example, in California property value assessments cannot increase more than two percent a year unless the property changes ownership.

The assessment limitations lead to continuous under-valuation of property that has not changed ownership. One of the strengths of the property tax is that its revenue increases automatically as property values increase. Thus, as inflation increases the costs of public services the property tax has naturally been capable of raising revenue to meet those rising costs. This attribute of the tax is severely diminished under a system using assessment limitations<sup>11</sup>.

Numerous studies have shown that tax limitations have reduced reliance on the property tax nationwide (see e.g., McCabe and Feiock 2000; Shadbegian 1998; Shadbegian 1999; Poterba

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<sup>11</sup> In addition eight states impose general expenditure limits and two states impose general revenue limits on local governments. These limitations are not specifically tied to property taxes. But they limit local fiscal autonomy just the same.

and Rueben 1995; Preston and Ichniowski 1992; Sexton, Sheffrin, and O'Sullivan 1999). The amount of property tax revenue foregone as a result of the various limitations is in the tens of billions of dollars nationwide. (O'Sullivan 2000).

It should be noted that in many states, political leaders taking advantage of anti-tax sentiments promised increased state aid to replace lost property tax revenue (Brunori 2001). Those promises encouraged citizen support for the tax limitations since the public believed that they could maintain adequate levels of service but transfer payment from local to state responsibility. That increased aid, however, never materialized -- at least not to the extent of the lost revenue.

There is little doubt that the public's unhappiness led directly to the tax limitations now in place. But while the public's attitude about property taxes may change, the limitations, often imposed by constitutional amendment, will be harder to amend or eliminate.

#### *ii. Tax Relief Measures*

A recent New Jersey study found that the poorest 20 percent of homeowners bore a relative property tax burden four times as great as the wealthiest one percent of homeowners (Coleman, Hughes, and Kelher 2001). And, Reschovsky (1994) found in a single year study that the property tax was regressive for both elderly and younger households, but decidedly more so for elderly households. Reschovsky also found, however, that when studied over a twelve-year period, the property tax for younger households was proportional.

Despite this debate, there is a clear, indeed profound, belief that the property tax is unfair to low and moderate income homeowners, particularly elderly homeowners (Youngman 1999A). For that reason, state governments have instituted various programs to relieve the property tax burden on homeowners.

Efforts to alleviate the burden have taken various shapes. Following is a description of the most widely used policies designed to ease the burdens of the property tax for low and moderate-income residents.

### **Homestead Exemptions**

Homestead exemptions are used in 28 states and the District of Columbia. They provide reductions in the amount of assessed value subject to taxation for owner occupied housing. While homestead exemptions provide some reduction for all homeowners, four states (Nebraska, North Dakota, Ohio, and Washington) phase out the exemption as income increases.

Homestead exemptions are based on the political belief that homeownership benefits the community and society (Youngman 1996). Homestead exemptions do not benefit renters and thus do not provide ability to pass on the tax savings in the form of lower rents.

Homestead exemptions are generally mandated by state law. Most states require local governments to absorb the costs of the exemption. Indeed, only 12 states<sup>12</sup> reimburse local governments for some or all of the costs.

### **Homestead Credits and Circuit Breakers**

In addition to homestead exemptions, many states provide credits directly to homeowners to alleviate the burdens of property tax liability. The credits generally are the same for all eligible households in a particular jurisdiction. These credits generally take the form of circuit breakers. Thirty states and the District of Columbia use circuit breakers. States offer tax credits to low and

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<sup>12</sup> The states that reimburse local governments for the costs of homestead exemptions are Maine, Oklahoma, Indiana, New Jersey, North Carolina, South Carolina, Wyoming, California, Massachusetts, North Dakota, Iowa, and Louisiana

moderate income homeowners, and in 26 states to renters. Four states provide circuit breaker relief only to homeowners.

Circuit breakers generally involve setting an income threshold that property tax liability cannot exceed. Homeowners and renters with property tax burdens exceeding the threshold receive the tax credits direct from the state. One third of the states provide the relief through income tax credits.

The advantage of using circuit breakers is that the state, rather than the local government, incurs the cost of the credits. Circuit breakers enable the state to target relief to those who need it the most. And a fully refundable credit makes the state income tax more progressive even in states with flat income tax rates.

### **Property Tax Deferrals**

One of the most effective, but underutilized, methods of providing property tax relief is through deferrals. Many states allow the elderly and disabled to defer property tax payments until the homes are sold or the taxpayer dies. Twenty-two states and the District of Columbia offer such programs. The deferred property taxes become liens against the value of the property. Local governments generally charge interest on the amount of tax liability deferred. When the property is sold, or when the homeowner dies, the local governments collect the unpaid property tax and interest.

Property tax deferrals are less expensive than homestead exemptions or circuit breakers. But as Youngman (2002) noted, deferrals are underutilized. In 2001, only 10 senior citizens in Boston took advantage of deferrals. And nationwide, only 1 out of 72 eligible households requested deferrals.

While it is true that the elderly generally do not like tax liens on their property, the elderly often have liens placed on their homes through second mortgages, home equity loans, and reverse mortgages. Thus, educating elderly homeowners of the benefits may lead to increased usage.

***b. School Finance Crisis***

A further limitation on local government reliance on property taxes has arisen from the ongoing school finance crisis. Traditionally, local governments were primarily responsible for paying for elementary and secondary school education, and they relied almost exclusively on the property tax. Of course, some jurisdictions had a property tax base to pay more for teachers, buildings, computers, and the like than poorer communities. Wealthier communities had more money per capita spent on their education than kids in poorer cities and counties. And that often translated into better schools.

For the past quarter-century, there have been a growing number of legal and political challenges to the inequality of public education finance. In a 1971 landmark ruling, *Serrano v. Priest*, the California Supreme Court declared the state's public school finance system illegal under the state constitution. By 2004, there had been challenges in 43 states, and courts in 19 states have declared that using the local property tax as the primary means of paying for schools is illegal.

Courts have ordered states to "equalize" funding of schools between rich and poor communities. The states usually reacted by earmarking certain statewide taxes to pay for public schools. For example, Michigan imposed an additional one percent statewide sales tax to pay for virtually all public school expenses (and tied that tax increase to a dramatic cut in the property tax). In 1999, New Hampshire adopted a statewide property tax. The tax was collected locally,

remitted to the state, and then redistributed to poorer communities. In 1997 Vermont, through Act 60, imposed a similar statewide property tax, which required localities to remit a portion of property tax revenue to the state for redistribution. In 1993, Texas enacted the "Robin Hood" law which required wealthier school districts to remit a portion of their revenue to the state for redistribution to the poor. The shift to statewide property taxes proved to be politically divisive (Brunori 2001). The political controversies stem from the fact that the property tax works if it is used to fund local governments, but generally fails as a means of redistributing wealth.

The result of increased centralization of school finance, has been a reduction in the use of property taxes in general. As Fischel (1989) noted, the property tax was acceptable as a vehicle for funding local education. But once the property tax was no longer the primary means of financing education, public support for the tax, meager to begin with, evaporated. Indeed, Fischel asserted that the school finance litigation was a cause of the property tax revolts, particularly with respect to California's Proposition 13. The Serrano court ordered sweeping reforms for the California education finance system, which resulted in redistributing wealth from high spending school districts to lower spending jurisdictions. According to Fischel, the Serrano case changed the property tax from a benefits tax to a statewide redistribution of wealth vehicle.

Under Fischel's hypothesis, voters in wealthier school districts voiced their displeasure with the redistributive effects of Serrano by supporting Proposition 13. This theory has been widely accepted by scholars. And its contribution to the understanding of Proposition 13 cannot be denied. Fischel's theory is consistent with the notion that education finance reform efforts draw much support from anti-tax activists who see the movement to centralize education finance as a means of lowering overall tax burdens (see generally Youngman 1997).

In any event, it is clear that state centralization of school finance has reduced reliance on the property tax. And state funding of schools, has made it more difficult for local governments to raise taxes in general, and property taxes in particular (Bowman, Mikesell, and MacManus 1992). Research by Murray, Evans, and Schwab (1995) and Bahl, Sjoquist, and Williams (1990) shows that school finance litigation has directly led to decreased reliance on the property tax. And, less reliance means less rationale for the property tax (See Sexton and Sheffrin 1995; and Break 2000).

The effect cannot be overstated. As Sheffrin (1999) noted, "School finance litigation is the single most important factor affecting property tax today. It ultimately undercuts the rationale for the property tax as a truly local tax. In my view, homeowners were willing to pay higher property taxes if they were convinced that this would lead to quality schools. The school finance litigation movement essentially breaks this tie."

### ***c. A Proliferation of Exemptions***

Besides the obvious loss of revenue created by the tax limitation movement, there are other factors that have deterred local governments from relying more heavily on property taxes. Exemptions for charitable organizations and economic development have proliferated over the past half-century. In addition, there are numerous exemptions for farm property and government owned property. The number of exemptions is staggering. For example, Thomas (1991) found that in many counties 60 percent of property was exempt from tax. These exemptions are generally imposed by state governments and cost local governments billions of dollars a year in revenue<sup>13</sup>.

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<sup>13</sup> California is typical. One study found that 68 different classes of property, ranging from parking

*i. Economic Development Exemptions*

A major challenge to the property tax has been the proliferation of exemptions in the name of economic development. State and local governments desiring to attract jobs and investment provide property breaks to companies promising to relocate to or remain in the jurisdiction. Exemptions for property taxes are natural targets for economic development policies (Youngman 1998). Indeed, they are the most common type of tax incentive offered by local governments.

The amount of money given away every year in the form of property tax incentives is difficult to determine because most states and local governments do not have tax expenditure reports. One study estimated that in 1996, state and local tax incentives totaled \$48.8 billion and one half of that amount was attributable to property tax incentives (Thomas 2000). Other more targeted studies show similar results. In 1996 alone, Cincinnati and Columbus, Ohio combined to offer more than \$600 million of property tax abatements to businesses (Thomas 2000).

It should be noted that when property tax exemptions are adopted, state political leaders often promise to reimburse the local governments for lost revenue. But, the state governments rarely follow through with enough funds to cover the losses attributable to property tax incentives (Brunori 2001).

The extensive use of property tax incentives to foster economic development has had a tremendous impact on local government reliance on the tax.

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facilities at places of worship to property owned by volunteer fire departments are exempt from tax (Micheli 2001).

## *ii. Charitable Exemptions*

Yet another challenge to the property tax has been the dramatic increase in the value of property held by charities and nonprofit organizations over the past quarter-century. All states have been affected by the increased use of charitable exemptions. A whole class of property is exempt from taxation -- property held by churches, synagogues, schools, charities, universities, and other nonprofits. All told, the total value of charitable property exempt from tax exceeds \$990 billion or about 7 percent of the total real estate values in the United States (Netzer 2002). The lost property tax revenue due to charitable exemptions, according to one study, is estimated to be as high as \$13 billion (Cordes et. al. 2002).<sup>14</sup>

Suffice to say, such exemptions exist and given the current political climate are unlikely to be repealed. But it cannot be denied that charitable exemptions further shrink the property tax base of most local governments. Organizations receiving exemptions use public services, which generally must be paid for by nonexempt taxpayers. As a result, nonexempt property owners as well as non-property owners (through other taxes) face higher tax burdens. This in turn increases the public's unhappiness with the property tax.

To alleviate the impact of lost revenue, most states allow the use of payments in lieu of taxes (PILOTs). PILOTs are voluntary payments made to local governments to defray the costs of public services. But payments in lieu of taxes (PILOTs) are not universally used. Indeed, in 1998 only 7 of the 51 largest cities in the United States actively solicited PILOTs from nonprofits (Leland 2002). There is no evidence that PILOTs come remotely close to covering the revenue that would be raised if the charitable property were not exempt.

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<sup>14</sup> The total loss of property tax revenue is probably considerably greater since this study excluded property owned by religious organizations which own an estimated one half of the total exempt property in the United States. (Cordes, et.al. 2002)

### ***iii. Farm Relief***

Another broadly used exemption is for farmland. Virtually every state provides property tax relief to owners of farms. The original motivation for such relief was preservation of the family farm. In addition, many environmentalists favor farm tax relief as a means of slowing urban and suburban sprawl.

Farm tax relief in 44 states primarily takes the form of preferential assessments. Farmland is valued at its current use, rather than at market value. In many instances, market value of farmland, particularly to land close to metropolitan areas, far surpasses the current use value. Owners of farmland are provided significant property tax relief. Except in Michigan and Wisconsin, these programs are not tied to income and benefit all owners of farmland. Studies have shown that tax relief programs have had little impact on the goal of preserving family farms or preventing urban sprawl (see Vitalliano 1999).

### ***iv. Government Property***

Although discussed to a much lesser degree, a significant amount of property is exempt from local tax because it is owned by either the federal or state governments. Although the exact amount of such property is difficult to ascertain, it is likely valued in the hundreds of billions of dollars nationwide<sup>15</sup>. Virtually all government-owned property is exempt from tax. The exemptions are derived from the Supremacy Clause of the United States Constitution, as well as from notions of sovereign immunity. The policy rationale for exempting government property is that it theoretically reduces the costs of government (Swain 2000). Federal and state

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<sup>15</sup> In Virginia alone, federal and state owned property was valued at \$44.3 billion in 1998 (Report of the Commission 2000).

governments often make payments in lieu of taxes to compensate for lost revenue. But these payments generally do not cover the revenue loss from the exempt property.

### **C. THE INCIDENCE OF THE PROPERTY TAX**

While it may seem obvious who pays property taxes, it is, in fact, not. (For a classic treatment, see Aaron 1975). Property taxes can be passed through in the form of higher rents to tenants, to nearby communities, from one type of property to another, and from one property value class to another. The word “incidence” defines the final resting place of taxes.

Our purpose here is to summarize what the economic literature tells us about property tax incidence from three perspectives: how it plays out among communities and inputs to production; its implications for progressivity; and division between landlords and tenants.

#### **1. The Idea of Incidence**

Before discussing the incidence of the property tax, it is worth discussing the concept of incidence. Zodrow (1999) discusses the three (increasingly realistic and therefore increasingly complex) approaches to analyzing incidence: partial equilibrium analysis, static general equilibrium analysis and dynamic general equilibrium analysis.

Partial equilibrium looks at a good being taxed in isolation: it simply looks at the supply and demand curves for individual goods, and does not consider how one good might interact with another. We will discuss the implications of this below.

Within a partial equilibrium framework, incidence is a function of the elasticities of supply and demand. If demand for a good is highly elastic—that is, highly sensitive to changes in prices—most of the incidence of a tax on that good will be borne by the producer of the good; conversely, if demand is inelastic, the consumer will bear the incidence.

To understand why this is true, consider the case where demand for a good is perfectly elastic—that is, if its price goes up, demand disappears entirely. Under these circumstances, the supplier of a good that has a tax placed upon it cannot pass through any of the tax to the consumer, or else it will lose all its business. The supplier absorbs the tax in its entirety.

On the other hand, if demand is perfectly inelastic, no amount of price change will change demand, and as a consequence, the supplier can pass through the tax with impunity.

While this kind of analysis can help glean certain insights, it is limited by the fact that it doesn't ask a basic question: when taxes cause people to spend less on one good, where does their money go? The purpose of general equilibrium analysis is to come up with the answer to just such a question.

Suppose, for example, one were to levy a tax on beef but not on chicken. If the demand for beef is somewhat elastic, beef consumption will fall. But people will not stop eating—rather, they will spend money on food other than beef. Let's say that the tax on beef causes chicken consumption to rise. If the supply of chicken is not perfectly elastic, the increased demand will cause the price of chicken to rise. This means that part of the tax on beef is being borne by consumers of chicken, because the tax increase flows through to an increased cost of chicken. Thus the incidence of the tax falls on consumers and producers of beef, but also on consumers of chicken.

But even this analysis fails to tell the whole story. It is very often the case that the supply of a good is inelastic in the short run but is more elastic in the long run—it takes awhile to build factories or chicken coops. Suppose that a tax on beef means that investors take money out of beef slaughterhouses and put it into chicken coops. Because there are generally diminishing marginal returns to capital, this will drive down the returns to chicken-coops, and therefore

investors in chicken-coops will also be taxed. This process is known as dynamic-general equilibrium analysis.

With this very brief overview of incidence analysis behind us, we can begin to discuss the incidence of the property tax.

## **2. The incidence debate**

Let us begin by just considering owner-occupied housing: because tenant and landlord are one and the same, we don't need to worry about how taxes are split between the two. But we do have to worry about whether the homeowner is actually bearing the burden of the tax she is writing a check for every year.

There is a fierce and friendly debate within the public finance community as to the incidence of the tax: on one side of the debate is William Fischel of Dartmouth, who takes what is called the "benefits view;" on the other side is George Zodrow of Rice, who takes what is called the "new view" or "capitalization view." Thomas Nechyba of Duke provides a gracious overview of the debate.

The benefits tax view basically maintains that the property tax is hardly a tax at all, but is rather a mechanism through which people pay for services. Communities have an incentive to provide a mix of taxes and services that maximize property values, and therefore will only levy taxes to the extent that the marginal benefit of those taxes exceeds the cost. Once governments tax beyond their need to spend, they will bring about declines in property values, which will undermine constituent confidence, thereby increasing the probability that the government will be voted out of office.

This view also explains the presence of exclusionary zoning in communities. Governments wish to be able to target services to a particular type of constituency, and will

therefore wish to preclude households who are not easily served or who do not pay much property tax outside of their jurisdictions.

Christopher Mayer and Christian Hilber provide powerful support for this view—using Massachusetts data, they show that in communities with restrictive land use policies, the capitalized land value of high quality schools exceeds the property tax cost of providing those schools. As a result of this, households who do not have children in school are still willing to vote to support high quality schools. This result illustrates the benefits view quite well.

The new view maintains that property is one of many things that can be taxed in order to provide government service, and by taxing housing in particular, governments drive down the value of housing and drive capital away from housing and toward other economic sectors. This has an important implication for incidence. A dynamic general equilibrium model of incidence predicts that as capital flows away from housing and into other investments, both the housing and other investments bear some of the tax burden.

This new view is consistent with Arnold Harberger’s view of capital taxes, which is that taxes on productive assets fall on all owners of capital.

### **3. The “Henry George” Tax view**

Among the most passionate participants in the property tax debate are the “Henry Georgists” who believe many of the incidence issues just discussed would become moot if municipalities raised funds using a “split-tax:” a property tax where the tax rate on land is substantially higher than the tax rate on improvements.

The argument is simple—because land is immobile, owners of land cannot escape taxation, and thus cannot shift the tax burden elsewhere. As such, a Henry George Tax has the properties of what economists call a Ramsey Tax—that is, a tax that doesn’t change behavior,

and is therefore efficient. The advocates of such a tax also maintain that landholder profit as the result of an implied monopoly—that they happen to gain market power in an area that becomes valuable because of circumstances, such as population growth and government-provided infrastructure, for which the landowner deserves no credit.

Proponents of the Henry George Tax also argue that such a tax would have the benefit of encouraging dense development and would also discourage speculative behavior, under which land owners just sit on land, hoping and waiting for it to rise in value.

The Georgist argument has much appeal, and many economists approve, in principle, of the idea of taxing land more heavily than improvements. But while it is true that land is in the short run immobile, in the long run one could argue in a sense that it is not—a place which may have great locational value one day may have little the next. The movement of jobs from the Midwest to the Sunbelt, for example, or from the central cities to suburbs suggests that the value of land is mobile.

Moreover, developers do engage in certain types of behavior that can influence the value of their land. For example, a shopping center developer who brings together a critical mass of retailers can be said to have created value. To the extent land is taxed more heavily in one place than other, it can drive developers from one place to another than therefore affect incidence. When developers are driven from one community to another, they will drive down the marginal return on investment in the community to which they move, and therefore shift the tax burden.

#### **4. Distributional Impacts of Property Tax Incidence**

The property tax has many merits, not least of which is the benefit tax feature described above—it allows people in a municipality to choose the mix of taxes and services they desire.

Because people can vote both at the ballot box and with their feet, government officials have a powerful incentive to provide an efficient mix of taxes and services.

Nevertheless, policymakers are legitimately concerned about the distribution implications of the residential property tax. The concern is a straightforward one: if household spending on housing declines as a percentage of income as income increases, a property tax that is passed through on a pro rate basis to housing consumption will fall more heavily on low-income household than high income households.

The view one takes on incidence will determine the view one takes on the distributional implications of the property tax. If one takes the Zodrow view, the burden of the property tax lies with owners of capital; such people have higher than average income and wealth (a fact well established in the Survey of Consumer Finances), and therefore the property tax winds up being progressive.

To some extent, the benefits view also suggests that the net impact of the property tax might be more progressive than anything else—low income households may pay a higher share of income on the property tax than households higher up the income distribution, but they may also well get far more benefits than they pay in taxes, meaning that the net effect for low-income households is more welfare enhancing than it is for other households.

If we look at the property tax in a more straightforward way—if we assume that incidence is closely related to statutory obligation—the distributional impact of the tax is still not entirely clear. In the first place, many jurisdictions have property tax policies designed to alleviate regressive impacts, such as “circuit-breakers” and tax-credits. These policies effectively reduce property tax burdens for households with incomes that fall below some critical point. Jurisdictions also have policies that create a tax system that departs from an ad valorem

structure: common cases of this include use valuation (where property is valued based on how it is currently used, rather than its highest and best use) and limits on changes in assessed value from year-to-year (Proposition 13 in California is the most dramatic example of this).

Beyond these complications, there is a disagreement between economists and policymakers about how to measure income for the purpose of determining tax equity. Economists generally prefer a life-cycle model of income, where tax burdens are measured against “permanent income.” Policymakers tend to focus instead on contemporaneous income. The distinction is important. Consider a college student living in an apartment. His tax burden relative to his current income is likely quite high, but relative to his lifetime income might be quite low.

Regardless of how one measures incidence, under a life-cycle framework, the property tax is more progressive than it is under a contemporaneous income framework. The reason for this is that households smooth housing consumption over their lives. For instance, when people first buy a house, their payment-to-income ratio is usually much higher than it is ten years after they buy a house. To some degree, households make housing choices based on what they think their income will be; not just based on current income. Hence, the relationship between housing expenses and income over the life-cycle is different than the contemporaneous relationship. People who choose a lot of housing when their income is low because they expect their income to rise are very different from people who choose less housing because they think their income will not rise very much.

The implications are important: in a contemporaneous income framework, the property tax appears regressive; in a life-cycle framework: a pure ad valorem property tax is more or less proportional among owner-occupiers (see Metcalf 1994).

On the other hand, property tax systems often depart from being purely ad valorem systems. For example, some places, such as Louisiana and Texas, have homestead exemptions, whereby some amount of property value is exempt from the property tax. Property tax systems sometimes also have special exemptions for the elderly.

The design of the homestead exemption determines how much they contribute to progressivity. Some homestead exemptions remove a fixed percentage of house value from the property tax rolls—and basically have no impact at all on progressivity (in fact, all they do is raise the statutory tax rate). On the other hand, most homestead exemptions exempt a certain dollar amount of property value from taxation, and these generally make property tax systems more progressive.

Louisiana has an especially large homestead exemption. Residential property in Louisiana is assessed at 10 percent of market value, meaning a \$100,000 house is assessed for tax purposes at \$10,000. Owner-occupants receive a \$7500 exemption on assessed value. This means that homeowners whose houses are worth less than \$75,000 pay no property tax at all in Louisiana. In the context of Louisiana, this exemption is particularly important, because even before Katrina, median house prices in Louisiana cities were just above \$100,000<sup>16</sup>. As a consequence, property taxes in that state are more progressive than they are elsewhere.

According to Goodman (2005), at least in part because of these exemptions, the incidence of property taxes on renter-occupied housing is 25 percent higher than it is on owner housing. He also finds that among renter-occupants, the property tax is roughly proportional to lifetime income.

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<sup>16</sup> According to Census 2000, the median price of a house in Louisiana in 2000 was \$84,000.

California's Proposition 13 presents a complicated case. While Proposition 13 has a number of characteristics, the most important is that assessed value that is the basis for the calculation of the property tax is tied to a house's acquisition value, rather than its market value. As a result, the incidence of the tax burden is largely a function of mobility: households that move often have a higher tax burden than those that do not. According to O' Sullivan, Sexton and Sheffrin (1994), this implies that on average low income people and the elderly pay less property tax than other in California; however, it is also the case that households in very similar income circumstances can pay very different tax rates, a condition known as horizontal inequity.

The Sullivan et al. analysis also does not consider an important implication of Proposition 13: that communities in California rely heavily on impact fees, rather than property taxes, for the provision of public infrastructure. This incidence of impact fees is unclear, but according to Dresch and Sheffrin (1997), every one dollar of impact fees in Contra Costs County, California drove up house prices from between 25 cents and \$1.88. This reinforces the impact that Proposition 13 has on tax rates: it tilts the incidence of the property tax away from property holders who have owned for a long time toward those who have recently purchased a house.

## **D. VARIATION IN USE OF THE PROPERTY TAX**

### **1. Regional Variations in Use and Role of Property Taxation**

Property tax reliance varies, often greatly, by region. U.S. local governments in the Northeast and Midwest have traditionally relied more heavily on property taxes than have local governments in the South or in the West (Minnesota Taxpayers Association 2001). In 2002, for example, New Hampshire, Maine, Rhode Island, New Jersey, Vermont, Connecticut, Wisconsin,

Wyoming collected the most property taxes as a percentages of income. Conversely, Alabama, Arkansas, Delaware, Hawaii, Kentucky, Louisiana, New Mexico, and Oklahoma collected the least. Not coincidentally, regions in the nation that rely most heavily on property taxes have also had the strongest commitment to local autonomy. Regions that rely least heavily on property taxes generally have more centralized state government functions (see Brunori 2003).

Differences within regions are also evident. New Jersey, for example, is considered a high-property-tax state. In 2002, local governments in New Jersey raised \$16 billion in property taxes, more than the revenue collected from the state's three largest taxes combined. The property tax accounted for 46 percent of all of New Jersey's state and local tax revenue in 2002. Moreover, New Jersey collected 98 percent of all its local own-source tax revenue from property taxes, compared with 73 percent nationwide. By contrast, in neighboring New York, the property tax accounted for 59 percent of all local own-source tax revenue, an amount well below the national average.

Similarly, in Alabama, traditionally a low-property-tax state, local governments raised a mere 39 percent of their total 2002 tax revenue from property taxes. But local governments in its border state, Mississippi, raised 92 percent of their total tax revenue from property taxes, more than most other states. Mississippi imposes a property tax burden of nearly twice that of Alabama in terms of percentage of personal income.

Another inter-regional difference exists between Texas and Oklahoma. In 2002, Texas had a per capita property tax of \$1,176. Oklahoma, by contrast, imposed a per capita property tax of only \$429.

## **2. Consequences of Variations**

There are two important consequences of regional and intra-regional variations in property taxation. First, states with greater reliance on property taxation generally have much more autonomous local government systems. Citizens in those states have more control over local public services through their elected local officials. This autonomy also results in less reliance on intergovernmental aid to fund local public services. States with greater reliance on property taxes have stronger local government systems (Brunori 2003). States with greater reliance on property taxes also have greater spending on traditionally local public services, particularly education and local transportation.

The second consequence of regional and intra-regional variations in property taxes is increased interjurisdictional competition. In general, many states, particularly those in the Deep South, have touted their low property tax burdens to attract economic development. While such competition is not limited to property taxes, the states with low property tax burdens have been more aggressive in trying to lure investment and development (Brunori 2003).

### **E. VARIATIONS IN PROPERTY TAXATION BY GOVERNMENT TYPE**

#### **1. State Governments**

The property tax is the only tax levied in all 50 states and the District of Columbia. Of the nearly \$280 billion in property tax revenues raised in 2002, school districts accounted for the highest amount (43% of total property revenues), followed by counties (22.2%), cities (20.9%), townships (6.8%), special districts (3.7%) and state governments (3.5%); see Table 6.

While the property tax was once the most important source of revenue for state governments, the role of the tax in state finance has greatly diminished. In 2002, state

governments collected only \$9.7 billion in property tax revenue. This represents about one percent of total state revenue.

**Table 6. Dollar Value and Share of Property Tax Receipts Received by Each Government Type**

<i>Government Type</i>	<i>2002 Property Tax Receipts</i>	
	<i>Dollar Value</i>	<i>Percentage</i>
State Governments	\$9,702,385	3.48%
Counties	\$62,060,054	22.23%
Cities	\$58,301,633	20.89%
Townships	\$18,833,577	6.75%
Special Districts	\$10,254,320	3.67%
School Districts	\$119,969,711	42.98%
All	\$279,121,680	100.00%

While the property tax is no longer very important to most states, there are exceptions. Seven states (Arkansas, New Hampshire, Michigan, Montana, Vermont, Washington, and Wyoming) raise more than eight percent of their revenue from statewide property taxes. The heavier reliance on property taxes in these states is attributable in part to: their decision not to impose sales or income taxes; or to the enactment of state property taxes as part of school finance reform.

## **2. Local Governments**

Traditionally, the property tax has been the primary source of tax revenue for local governments. The property tax is imposed by counties in 45 states, municipalities in 49 states, townships in 24 states, school districts in 42 states, and special districts in 20 states. Not surprisingly, the reliance on the property tax varies by type of local government. Historically, of all types of local governments, large U.S. cities have relied on property taxes the least (Brunori

2003). This lesser reliance has become even more pronounced since the property tax revolts of the late 1970s. Large cities, because of their geographic size and intense commercial activity, have many more opportunities to raise revenue from other sources, such as levies on sales and income.

**Table 7. Percentage of General Revenue from Property Tax For Each of Government Type**

<i>Government Type</i>	<i>Percentage</i>
State Governments	1.33%
Counties	39.27%
Cities	29.09%
Townships	72.74%
Special Districts	16.61%
School Districts	79.32%

Table 7 sets forth the substantial variation among government types in the share of total own-source revenue provided by the property tax.

With respect to own-source revenues, independent school districts have relied most heavily on property taxes. In 2002, independent school districts raised more than \$119 billion, or about 95 percent of their total tax revenue and about 79 percent of their total own-source revenue, from property taxes.

With respect to total revenue, townships actually rely most heavily on the property tax. In 2002, townships raised approximately \$18 billion, or 73 percent of their total revenue, from property taxes. Unlike independent school districts, townships do not receive most of their income in the form of intergovernmental aid. The lack of support from state government, and the scarcity of viable alternative sources of revenue, has resulted in townships relying more heavily on the property tax than other general local governments.

Smaller cities and counties have relied more on the property tax than have large cities, but they depend on it less than independent school districts. Unfortunately, few data are available on the use of the property tax by smaller cities. But U.S. Census data show that in 2002, all municipalities in the United States raised \$58 billion, or about 15 percent of their total revenue, from property taxes. Municipalities raised about 28 percent of their total tax revenue from property taxes in 2002. At the same time, American counties raised approximately \$62 billion, or 39 percent of their total revenue, from property taxes. Although revenue from property taxes accounts for a relatively small percentage of total revenue, about 69 percent of counties' total tax revenue comes from property taxes.

Special districts also raise the bulk of their tax revenue from property taxes. In 2002, special districts raised about \$10 billion, or 71 percent of their tax revenue, from property taxes. Special districts, however, rely much more heavily on user fees and charges than other types of government do. Accordingly, property taxes accounted for only 17 percent of total special district revenue.

As noted above, the often dramatic variations in property taxation across regions is attributable to the legal and political structure of state governments and their political subdivisions. Those states with traditionally strong and autonomous local governments (i.e., those in the Northeast and Midwest) generally rely more heavily on property taxes. This is not surprising. The property tax has long been considered the ideal source of revenue for local governments in part because the tax allows for maximum local political control (Brunori 2003). Indeed, studies have shown a direct link between local autonomy and reliance on property taxation (Shuford and Young 2000).

The variations in property taxation by type of government are attributable to several factors. First, and most importantly, all government types possess only the taxing authority granted to them by their states. Thus, the level of taxation allowed by a particular type of government is limited by state law and a function of the state political process.

While state law dictates whether (and in many circumstances the extent) particular local governments can tax property, there are other factors. Townships in the United States rely relatively heavily on property taxation because 1) they receive little state intergovernmental aid, and 2) they do not have many alternative sources of tax revenue. Large cities, on the other hand, have always relied less heavily on property taxes than other types of government. This lesser reliance is attributable to the fact that large cities have been able to use sales and income taxes to raise revenue. Similarly, independent school districts rely heavily on property taxes because most are not authorized to impose other types of taxes.

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